

# Arizona State Retirement System

## Incentive Compensation Plan for Investment Staff

### Contents

Authority .....	2
Purpose and Objectives .....	2
Eligibility for Participation.....	2
Participant Eligibility for Other Approved Compensation Strategies.....	3
Performance Period.....	3
Maximum Incentive Compensation Opportunity .....	3
Performance Categories.....	3
Internal Portfolio Performance .....	3
Asset Class Performance .....	3
Total Fund Performance .....	4
Qualitative Performance .....	4
Performance Categories Weightings and Expected Net Excess Returns.....	7
Award Distribution .....	5
Payment Date .....	5
Treatment of Payments.....	5
Employment Status.....	5
Administration.....	5
Effective Date.....	6
Record Keeping and Reporting.....	6
APPENDIX A: Responsibility Matrices .....	8
APPENDIX B: Performance Benchmarks.....	10
APPENDIX C: Example.....	12

# **Arizona State Retirement System Incentive Compensation Plan for Investment Staff**

## **Authority**

A.R.S. § 38-611.01 provides that the ASRS may administer an incentive compensation plan (hereafter the “ICP”) for investment related personnel. This document describes the ICP and specifies the methods and procedures related to the administration of the ICP.

Nothing in this document is intended to alter the nature of ASRS employment or to create or be construed as creating an expressed or implied contract of employment or to define conditions of employment. This document does not provide a contract, guarantee of payment, guarantee of participation in the incentive plan in subsequent years, or guarantee of employment with the ASRS. The ICP and the payments that result from the ICP are public information and will be disclosed upon request.

In addition, upon consultation with ADOA the ASRS reserves the right to alter, amend, modify, rescind, or otherwise change the content of the ICP at any time for any reason as permitted by law, in its sole discretion, and without advance notice to any employee affected by the provisions of the ICP.

## **Purpose and Objectives**

The purpose of the Incentive Compensation Plan (“ICP”) is to further enhance the investment management and performance of the ASRS Trust Fund.

In order to achieve this purpose, the Incentive Compensation Plan (“ICP”) has been designed to contribute to the ASRS’s ability to meet the following objectives:

1. Retain high caliber investment professionals  
(By providing performance based compensation).
2. Attract high caliber investment professionals  
(By providing performance based compensation.)
3. Incentivize investment performance  
(By aligning investment personnel compensation with investment results.)

## **Eligibility for Participation**

To be eligible to participate (a “Participant”) in the ICP an ASRS employee must be:

- Allocated to Investment Management as determined by the Director or Board.

If an employee begins employment in an eligible position after July 1, the employee will become a Participant on the first date of employment and participation will be prorated based on the total number of days employed during the Performance Period.

### *Participant Eligibility for Other Approved Compensation Strategies*

Participants in the ICP remain eligible to participate in compensation strategies (including recognition, retention, merit-based base salary adjustments, etc.) that are employed by the State of Arizona or the ASRS with the following exception:

- Any strategy or combination of strategies whose express purpose is to provide incentive to achieve performance-based goals and the opportunity to receive variable pay (i.e., pay that is not considered part of base salary).

The ICP will provide the only opportunity for Participants to receive variable pay for goal- and merit-based purposes.

### **Performance Period**

For purposes of the ICP, the Performance Period is the state fiscal year, which begins on July 1 of each year and ends on June 30 of the following year.

### **Maximum Incentive Compensation Opportunity**

A participant has the opportunity to earn incentive compensation up to 25% of the base salary in effect on July 1 of the Performance Period.

### **Performance Categories**

Incentive compensation categories were developed to have the following characteristics:

- Result in enhanced investment performance
- Controlled or influenced by Participants
- Fair
- Achievable
- Measurable
- Flexible for the agency

Performance Categories:

#### *1. Internal Portfolio Performance: 25% Weight*

Portfolio performance is measured on 1 and 3 year historical net returns, as of June 30, relative to established benchmarks (see Appendix B), with each period, including the implementation period, weighted equally at 50%. Each portfolio will be dollar weighted to determine the overall excess performance. Any new internally managed portfolios will be included during the first available full month of performance utilizing relevant benchmarks.

#### *2. Asset Class Performance: 25% Weight*

Asset class performance is measured on 1 and 3 year historical asset class net returns, as of June 30, relative to established benchmarks (see Appendix B), with each period, including the implementation period, weighted equally at 50%.

3. *Total Fund Performance: 25% Weight*

Total fund performance is measured on 1 and 3 year historical net rates of return, as of June 30, relative to the ASRS Strategic Asset Allocation Policy benchmark (see Appendix B), with each period, including the implementation period, weighted equally at 50%. Total fund represents aggregate Plan, System and Health Benefit Supplement (HBS) assets.

4. *Qualitative Performance: 25% Weight*

Individual and team goals, objectives, and other contributions and attributes will be reviewed. Evaluation criteria may vary by Participant and will be designed to reflect desired organizational attributes such as leadership, organizational competence, interpersonal relationship skills, effective teamwork, accountability, training and mentoring, project participation, process improvement, and other factors. Each year, criteria will be developed and documented by the CIO and/or Director for each Participant as part of this program and the statewide Managing Accountability and Performance (MAP) process. Consideration will be given to compliance exceptions, investment risks, reputational risks, and ethics violations.

Participants may earn between 0% and 25% of their base pay as incentive compensation.

The points allocated to Participants for each category will be calculated based upon the proportionate Actual Outperformance as a ratio of the Excess Return Target. Achieving 80% of the Excess Return Target would result in receiving 80% of the points for that category. Achieving 20% of the Excess Return Target would result in receiving 20% of the points for that category. Outperformance in at least one of the first three performance categories (Internal Portfolio, Asset Class, and Total Fund) must occur for any incentive compensation to be earned. In other words, no incentive compensation will be paid if the only out-performance occurs in the qualitative category.

In order to align and reward superior performance over the Excess Return Targets, up to 30 points can be earned in each category. If the sum of the points in each category totals more than 100, then 100 points will be allocation. Achieving superior performance in any category can make up for lower points in another category, but the total of all the points cannot exceed 100. If superior performance leads to surpassing the Excess Return Targets, then points above 25 and to a maximum of 30 will be allocated to Participants for the particular category and will be calculated based upon the proportionate Actual Outperformance as a ratio of the Excess Return Target. Achieving 110% of the Excess Return Target would result in receiving 110% of the points for that category. Achieving 120% of the Excess Return Target would result in receiving 120% of the points for that category. Achieving in excess of 120% of the Excess Return Target would result in receiving 120% of the points for that category.

Private Market investment returns will be calculated using since-inception internal rates of return (IRR) for all new investments initiated on or after October 1, 2011, which is the beginning of the first full quarter since the retention of the new Private Markets Manager.

All returns utilized will be calculated or reviewed by the ASRS external general investment consultant.

All weightings and other methodological issues will be determined or calculated by the ASRS Budget Manager.

### **Award Distribution**

*The distribution of all and any award is subject to available funding, as determined solely by the ASRS Director. If the Director determines that funding is not available, ICP payments will be either pro-rated or not made at all. If ICP payments are pro-rated or not made at all, the Director, at his discretion, may, or may not, make retroactive payments in the future when funding is available.*

Should an error be discovered after the payment date, the ASRS may make an adjustment and recover payments, including offsetting future compensation, or make additional payments.

#### *Payment Date*

When made, ICP payments will be made on or before September 30 following the close of the Performance Period (fiscal year ended June 30).

#### *Treatment of Payments*

All payments under the ICP are subject to any deductions and withholdings required by federal, state, or local law at the time of payment. The ASRS is not obligated to otherwise advise an employee of the existence of any amounts that ASRS is required to withhold.

The payments will be lump sum and not spread out over the year.

The performance pay will be considered “compensation” and will have retirement contributions paid on it by both the employee and the employer at the time it is paid.

#### *Employment Status*

A Participant must be considered in “good standing” on the payment date to be eligible to receive an award payment. That is, the employee must not be subject to current or pending corrective action, which includes working under a performance improvement plan.

A Participant also must be employed by the ASRS on the scheduled payment date to be eligible to receive an award payment. A Participant will not receive any payment, either in full or on a pro-rated basis, if they separate for any reason, including resignation, retirement, disability, death, or involuntary termination, prior to the date of payment.

### **Administration**

The ASRS Director will administer the ICP, with oversight by the ASRS Board of Trustees. Specifically, the Director will notify the Board of the individual and aggregate ICP payments made to each employee on or before September 30, following the close of the Performance Period (fiscal year ended June 30). The Director will also notify the Board if ICP payments are not made due to non-availability of funding.

The ICP will be in compliance with all applicable state or federal laws, regulations, policies, and guidelines. The ASRS Director will have full discretion to decide all questions or matters relating to the interpretation of the ICP and its administration.

#### *Power to Amend*

The ICP may be amended by the Director upon:

1. Presenting amendments to the ASRS Investment Committee for acceptance
2. Notifying the full Board
3. Consultation with ADOA

#### *Effective Date*

The initial Performance Period for the ICP will begin July 1 of the year the plan is adopted and a copy filed with the governmental offices required by A.R.S. § 38-611.01.

#### *Record Keeping and Reporting*

All performance, salary, and incentive compensation records for the ICP will be maintained by ASRS Human Resources in accordance with established records retention schedules and requirements.

DRAFT

## Performance Category Weightings and Net Excess Return Targets

**Public Market** performance objectives will be weighted as follows:

Internal Portfolio(s) Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
25	25	25	25	100

**Public Market** net (after investment expenses) excess return targets as follows:

Internal Portfolio(s) Excess Return Target (bps)	Asset Class Excess Return Target (bps)	Total Fund Excess Return Target (bps)	Qualitative Performance
10	25	40	Determined by CIO and/or Director

**Private Market** performance objectives will be weighted as follows:

Separate Account and Co-Investment Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
25	25	25	25	100

**Private Market** net (after investment expenses) excess return targets as follows:

Separate Account and Co-Investment Excess Return Target (bps)	Asset Class Excess Return Target (bps)	Total Fund Excess Return Target (bps)	Qualitative Performance
Absolute x	Absolute x	40	Determined by CIO and/or Director

## APPENDIX A: Responsibility Matrices

### Chief Investment Officer

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
All Internal Portfolios	All Asset Classes	Total Fund	MAP	100

### Assistant Chief Investment Officer/Senior Equities Manager

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
All Internal E Portfolios	All Public U.S. and Non-U.S. Equities	Total Fund	MAP	100

### Assistant Equity Portfolio Manager

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
All Internal E Portfolios	All Public U.S. and Non-U.S. Equities	Total Fund	MAP	100

### Assistant Equity Portfolio Manager

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
Securities Lending, All Internal E Portfolios	Externally-managed U.S. and Non-U.S. Equity Portfolios	Total Fund	MAP	100

### Fixed Income Portfolio Manager

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
All Internal F Portfolios	All Public and Private Fixed Income	Total Fund	MAP	100

### Portfolio Analyst

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
All Internal F Portfolios	All Public and Private Fixed Income	Total Fund	MAP	100



### Investment Analyst

Internal Portfolio Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
All Internal F Portfolios	All Public and Private Fixed Income	Total Fund	MAP	100

### Head of Private Markets Investing

Separate Account and Co-Investment Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
Separate Accounts, Co-Investments	All Private Markets and REITS	Total Fund	MAP	100

### Private Equity Portfolio Manager

Separate Account and Co-Investment Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
Separate Accounts, Co-Investments	All Private Markets, REITS, and Commodities	Total Fund	MAP	100

### Private Markets Asset Manager

Separate Account and Co-Investment Performance	Asset Class Performance	Total Fund Performance	Qualitative Performance	TOTAL Points
Separate Accounts, Co-Investments	All Private Markets and REITS	Total Fund	MAP	100

## APPENDIX B: Performance Benchmarks

### **Internal Portfolios & Separate Accounts & Co-Investments**

E2:	S&P 500 Index
E3:	S&P 400 Growth Index
E4:	S&P 400 Value Index
E6:	S&P 600 index
E7:	MSCI USA High Dividend Yield Index
E8:	MSCI USA Minimum Volatility Index
F2:	Barclays Capital Aggregate Index

PE Separate Accounts:	x% Absolute Return
PE Opportunistic Separate Accounts:	x% Absolute Return
PE Co-Investments:	x% Absolute Return

RE Core Separate Accounts:	x% Absolute Return
RE Opportunistic Separate Accounts:	x% Absolute Return
RE Co-Investments:	x% Absolute Return

### **Asset Classes**

#### **Public Markets:**

Asset Class benchmarks as explicitly denoted on the ASRS Strategic Asset Allocation Policy Schematic (SAAP).

#### **Private Markets (including REITS & Commodities):**

Private Market asset-class returns will consist of Private Equities, Inflation Linked Assets (Private Real Estate, REITS, Commodities, Farmland, and Infrastructure), and Opportunistic Private Equities.

The Asset Class return for Private Markets will be a dollar weighted composite of Private Equities, Inflation Linked Assets (Private Real Estate, REITS, Commodities, Farmland, and Infrastructure), and Opportunistic Private Equities.

Private Market investment returns will be calculated using since-inception internal rates of return (IRR) for all new investments initiated on or after October 1, 2011, which is the beginning of the first full quarter since the retention of the new Private Markets Manager.

REIT investment returns will be calculated using time-weighted rates of return. for all new investments initiated on or after October 1, 2011, which is the beginning of the first full quarter since the retention of the new Private Markets Manager.

Commodity investment returns will be calculated using time-weighted rates of return for all new investments initiated on or after October 1, 2011, which is the beginning of the first full quarter since the retention of the new Private Markets Manager.

## APPENDIX B: Performance Benchmarks

The Asset Class benchmark return for Private Markets will be a dollar weighted composite of Private Equities, Inflation Linked Assets (Private Real Estate, REITS, Commodities, Farmland, and Infrastructure), and Opportunistic Private Equities, with the following benchmarks:

PE GP/LP Accounts: x% Absolute Return

RE GP/LP Core Accounts: x% Absolute Return

RE GP/LP Opportunistic Accounts: x% Absolute Return

REIT: NAREIT

Farmland: x% Absolute Return

Infrastructure: x% Absolute Return

### **Total Fund**

ASRS Total Fund Return: Strategic Asset Allocation Benchmark Returns.

## APPENDIX C: Example

### Sample Calculation of Award

Steps to calculate amounts for distribution:	<p>For purposes of this example, we use the following assumptions:</p> <ul style="list-style-type: none"><li>• Position is Public Markets Senior Portfolio Manager</li><li>• July 1 base salary is \$100,000</li><li>• Maximum incentive opportunity is 25%</li><li>• Each category (Internal Portfolio, Asset Class, Total Fund, and Qualitative) is worth a possible 25 points (or 30 points for excess) to equal 100 points</li><li>• Expected net excess return is 5 bps for portfolio and 25 bps for asset class and total fund</li><li>• Actual Performance taken from Board update (illustrative only):</li></ul> <table><tr><td>Category</td><td>1-year (50%)</td><td>3-year (50%)</td></tr><tr><td>Internal Portfolio</td><td>33 bps</td><td>29 bps</td></tr><tr><td>Asset Class</td><td>-10 bps</td><td>10 bps</td></tr><tr><td>Total Fund</td><td>-100 bps</td><td>10 bps</td></tr><tr><td>Qualitative</td><td>Meets</td><td>Exceeds</td></tr></table>	Category	1-year (50%)	3-year (50%)	Internal Portfolio	33 bps	29 bps	Asset Class	-10 bps	10 bps	Total Fund	-100 bps	10 bps	Qualitative	Meets	Exceeds																									
Category	1-year (50%)	3-year (50%)																																							
Internal Portfolio	33 bps	29 bps																																							
Asset Class	-10 bps	10 bps																																							
Total Fund	-100 bps	10 bps																																							
Qualitative	Meets	Exceeds																																							
1. Determine maximum incentive compensation opportunity (See <u>Maximum Incentive Compensation Opportunity</u> section)	<p>\$100,000 X 25% = \$25,000</p>																																								
2. Identify established performance categories and compare to actual performance (See <u>Performance Categories</u> section)	<table><tr><td></td><td>1-year</td><td></td><td>3-year</td><td></td></tr><tr><td>Category</td><td>Expected</td><td>Actual</td><td>Expected</td><td>Actual</td></tr><tr><td>Internal Portfolio</td><td>5 bps</td><td>33</td><td>5 bps</td><td>29</td></tr><tr><td>Asset Class</td><td>25 bps</td><td>-10</td><td>25 bps</td><td>10</td></tr><tr><td>Total Fund</td><td>25 bps</td><td>-100</td><td>25 bps</td><td>10</td></tr><tr><td>Qualitative^</td><td></td><td>Meets</td><td></td><td>Exceeds</td></tr></table> <p>(^Note: The qualitative performance points are determined by the CIO and the Director, depending on individual objectives achieved and contributions made.)</p>		1-year		3-year		Category	Expected	Actual	Expected	Actual	Internal Portfolio	5 bps	33	5 bps	29	Asset Class	25 bps	-10	25 bps	10	Total Fund	25 bps	-100	25 bps	10	Qualitative^		Meets		Exceeds										
	1-year		3-year																																						
Category	Expected	Actual	Expected	Actual																																					
Internal Portfolio	5 bps	33	5 bps	29																																					
Asset Class	25 bps	-10	25 bps	10																																					
Total Fund	25 bps	-100	25 bps	10																																					
Qualitative^		Meets		Exceeds																																					
3. Convert actual performance (in bps) to award points (See <u>Performance Categories Weightings and Expected Net Excess Returns</u> section)	<table><tr><td></td><td>1-year</td><td></td><td>3-year</td><td></td></tr><tr><td>Category</td><td>(12.5 pts)</td><td>+</td><td>(12.5 pts)</td><td>= 25 pts</td></tr><tr><td>Internal Portfolio</td><td>15 (33&gt;=120% of points)</td><td></td><td>15 (29&gt;=120% of points)</td><td>30.00</td></tr><tr><td>Asset Class</td><td>0 (-10=0% of points)</td><td></td><td>5 (10=40% of points)</td><td>5.00</td></tr><tr><td>Total Fund</td><td>0 (-100=0% of points)</td><td></td><td>5 (10=40% of points)</td><td>5.00</td></tr><tr><td>Qualitative^</td><td></td><td>Meets</td><td></td><td>Exceeds</td></tr><tr><td></td><td></td><td></td><td></td><td>20.00</td></tr><tr><td></td><td></td><td></td><td></td><td>60.00</td></tr></table>		1-year		3-year		Category	(12.5 pts)	+	(12.5 pts)	= 25 pts	Internal Portfolio	15 (33>=120% of points)		15 (29>=120% of points)	30.00	Asset Class	0 (-10=0% of points)		5 (10=40% of points)	5.00	Total Fund	0 (-100=0% of points)		5 (10=40% of points)	5.00	Qualitative^		Meets		Exceeds					20.00					60.00
	1-year		3-year																																						
Category	(12.5 pts)	+	(12.5 pts)	= 25 pts																																					
Internal Portfolio	15 (33>=120% of points)		15 (29>=120% of points)	30.00																																					
Asset Class	0 (-10=0% of points)		5 (10=40% of points)	5.00																																					
Total Fund	0 (-100=0% of points)		5 (10=40% of points)	5.00																																					
Qualitative^		Meets		Exceeds																																					
				20.00																																					
				60.00																																					
4. Convert points to a percentage	<table><tr><td>Total Points</td><td>= Percentage</td></tr><tr><td>60.00</td><td>60.00%</td></tr></table>	Total Points	= Percentage	60.00	60.00%																																				
Total Points	= Percentage																																								
60.00	60.00%																																								
5. Determine award amount to distribute	<p>60.00% * \$25,000</p> <p><u>\$15,000.00</u></p>																																								